

APPENDIX

July 27, 1988

As reported during the telephone conference call on July 20,* the Bank of Mexico has approached the Federal Reserve to request a drawing of its full \$700 million swap line with the Federal Reserve. (The actual drawing might be in two parts: the first on August 1 and the second later in the month.) The purpose of the drawing would be to assist the Bank of Mexico in connection with public announcements on August 4 and September 1 of Mexico's international reserves. Mexico's international reserves, while still large, have shown a substantial decline since an official Mexican reserve figure was publicly announced earlier this year. The drawing would be on Monday, August 1 and would be repaid on Thursday, September 15. The funds drawn would be held at the Federal Reserve Bank of New York and would be invested in a U.S. Treasury Certificate of Indebtedness. The interest rate on the Certificate of Indebtedness would be adjusted to set the net cost to the Bank of Mexico at an annual rate of 1/4 of one percent. The Bank of Mexico intends to draw on its \$300 million swap line with the Exchange Stabilization Fund at the same time it draws on the Federal Reserve swap line and on the same financial terms.

Mexico has made considerable progress in recent years in restructuring its economy and in seeking to lower the inflation rate and the size of its public sector deficit. Since March 1988, the Mexican anti-inflation program has

*/ Conference call was held on July 19, not July 20.

involved further efforts to reduce the public sector deficit and a freeze of public sector prices, minimum wages, the peso/dollar exchange rate, and private sector prices that are subject to price controls. The freeze has been extended twice, most recently to the end of August. Although during the freeze the recorded inflation rate and nominal interest rates have declined, price distortions are emerging and the freeze has produced a real appreciation of the peso. Concern over the viability of the exchange rate, combined with political uncertainties generated by the recent election and the transition of administrations, has led to capital outflows, with a resultant reserve drain in recent weeks.

In light of the established swap relationship with the Bank of Mexico and the desirability of continuing to work with Mexico in an open and constructive manner in support of Mexico's efforts to follow through on its stabilization program, I would recommend that we accommodate the request by the Bank of Mexico for a drawing on its swap line with the Federal Reserve. No risk would be involved because the full proceeds of the drawing would be held at the Federal Reserve Bank of New York.

Greenspan